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BETTER THAN BEST EXECUTION? – THE FINANCIAL SERVICES AUTHORITY'S NEW PROPOSALS TO REFORM UK BEST EXECUTION REQUIREMENTS

In this bulletin, we review the UK Financial Services Authority's most recent consultation paper¹ which proposes significant changes in the obligations of firms to provide their customers with "best execution".

THE CURRENT POSITION

The current rules on best execution provide² that a firm must: (1) take reasonable care to ascertain the price which is the best available for the customer order in the relevant market at the time for transactions of the kind and size concerned; and (2) execute the customer order at a price which is no less advantageous to the customer unless the firm has taken reasonable steps to ensure that it would be in the customer's best interests not to do so.

In taking "reasonable care", the rules provide amongst other matters that (i) firms should disregard any charges and commissions made by it or its agents that are disclosed to the customer; (ii) they are not bound to have access to competing exchanges or all of them, or to any minimum number of available price sources, but if they do have such access to a variety and can make a comparison, it should execute the customer order at the best price available to the firm on those exchanges or trading platforms, if that is in the best interests of the customer.

One of the key rules provides that in relation to a customer order for shares that are traded on SETS, the electronic trading service operated by the London Stock Exchange, the firm is automatically regarded as having fulfilled its best execution obligations if it executes the customer order through SETS unless (ii) above applies. This is an important "safe-harbour".

As a second but allied obligation, firms are obliged to give timely execution, being an obligation upon a firm once it has agreed or decided in its discretion to execute a current customer order to do so "as soon as reasonably practicable". However, this obligation does not apply if a firm has taken reasonable steps to ensure that postponing the execution of a current customer order is in the best interests of the customer. Neither the rules on best execution nor timely execution apply to market counter parties, and firms may contractually agree with intermediate customers that they do not owe them a duty to provide best execution. Firms additionally should have compliance and monitoring procedures to ensure compliance with these existing obligations.

The FSA's Consultation Paper makes proposals in two separate and distinct areas, the first of which involves extensively modifying these existing best and timely execution obligations. Secondly, it proposes wholesale

¹ CP 154 published on 7 October 2002.

² COBS Rules in the FSA Handbook, Rules 7.5 or 7.6.

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reform of the processes surrounding execution, namely transparency of execution arrangements, obligations to review those arrangements generally and to monitor execution quality.

RESTRUCTURING THE BEST EXECUTION OBLIGATION

1. A move away from “best price”. At the heart of the FSA’s proposals is a move away from simply seeking “best price” towards the new concept of “quality of execution”; achieving the “best result” for the consumer by looking at the overall process of execution. Whilst price remains important, other factors would now have to be taken into account in meeting the revised obligations.

In addition to price alone, the FSA has focused on the cost of trading decisions and outcomes, looking at the net result for customers inclusive of trading costs, both direct and indirect. These other costs will, if the FSA’s proposals are implemented, have to be brought into account in achieving best execution.

Examples of direct costs which would need to be brought into account are commissions levied by intermediaries, clearing, settlement and custody charges and taxes. Indirect or implicit costs identified are market impact - the adverse price movement which can occur once information in a transaction has become known to the market place - and the opportunity cost - the cost implicit in a decision to trade on a phased or patient basis that arises where the market moves before the trade strategy has been fully implemented.

The FSA has said, however, that there still need not be included in any assessment of best execution those direct costs which are absorbed by the firm and not passed on to the customer such as exchange fees, and secondly transaction charges or investment management fees which are known and agreed separately by the customer and are separate and distinct from charges of third parties.

The FSA recognises that this also has implications for incentive arrangements designed to encourage customers to place business with particular brokers or execution venues, including notably the provision of investment research and related services, soft commission arrangements etc. The FSA appears to be saying that, since such arrangements may distort decisions on trade execution and could result in more expensive trading outcomes to the disadvantage of the underlying customer, they too will have to be taken into account.

In short, the FSA is proposing that commission costs and other costs of trading (other than those specifically excluded) should now form part of a revised approach to best execution, and this proposal would seem to go so far as to include soft commission and other similar arrangements. In practice, firms will have to take into account a far wider range of factors as well as price, some of them having less than immediately tangible values, making the task of achieving best execution more complex and more onerous.

2. Other dimensions of a customer’s order. Secondly, whilst the current obligations of best execution require firms to consider price by reference to “transactions of the kind and size concerned”, which takes into account order size, type and timing, the FSA indicates that there may be other dimensions to the order that are key for the customer. Examples given are customers’ preferred settlement arrangements and counter party limits.

3. Timely execution. In terms of timely execution, the FSA recognises that current obligations focus upon a requirement for *immediate* execution. They consider that a regulatory focus on immediacy of execution could be inappropriate in circumstances where a decision on timing is material to delivering the best outcome for the client. The FSA proposes to scrap the current timely execution obligation and replace it with an obligation of more general character, requiring a firm to deal at the time “best calculated to deliver the desired result for the customer”. Whilst the presumption of immediacy would be removed, giving greater discretion to firms, the revised obligation may in practice prove more difficult to measure or satisfy.

4. Benchmarking. The FSA’s paper then goes on to consider the current SETS “safe harbour” or benchmark, whereby if trades in those securities traded on SETS are executed through SETS or elsewhere at the equivalent of the SETS price, that would be sufficient to meet a firm’s best execution obligation (unless the firm is in fact able to execute the trade through another execution venue at a better price). The FSA proposes that incorporating the SETS price in best execution requirements as a “safe harbour” or minimum standard is no longer justified, and that it should be removed.

CUSTOMER DISCLOSURE, REVIEW OF EXECUTION ARRANGEMENTS AND MONITORING

As an adjunct to the reform of best execution obligations themselves, the FSA considers that it is also necessary to make changes in three further areas; the

provision of information to consumers on firms' execution arrangements, obligations on firms to review and make changes to those arrangements, and obligations to monitor the quality of execution actually achieved.

1. Customer disclosure. In terms of the provision of information to customers, the FSA suggests this could comprise three main components, the first being a description of the firm's execution policies and procedures and the execution service on offer (which could also include details of how prices are researched). The second component would be information on execution venues. The FSA is considering two options, simply to list the execution venues to which a firm has access, alternatively to require a firm to disclose details of its actual order flow through particular execution venues (by way of a historical analysis). The third component would comprise information on conflicts of interest, describing arrangements that might exist between the firm and the execution venue which provide or constitute an incentive for the firm to route orders through that venue rather than to another. The FSA recognises that there is an existing obligation to disclose a number of these matters in the terms of business with customers, but it proposes that these disclosures should, in the context of best execution, be directly related to the nature of the firm's execution service in a way which would help the customer to make a judgment on the quality of that execution service. In terms of disseminating the additional information, the FSA says it could be included in the firm's terms of business, some of the information could form part of a contract note, it could be included in general information in marketing materials, it could be provided via the firm's web site or could be provided on an ad hoc basis to customers.

2. Review of execution arrangements. The FSA also proposes that firms should be required to review their execution arrangements regularly by means of a comparison between execution venues available to each firm and others which it could access. In assessing those execution arrangements, firms should not only consider price, but other transaction costs, access costs, depth of the market and the likelihood of achieving execution, and other services provided by the execution venue such as research provided by a broker to an investment manager. If such a review, which the FSA proposes should be carried out at least annually, indicates that a change might be appropriate, the FSA would not expect or oblige the firm to change its arrangements automatically, but it would expect the firm to be able to substantiate a decision taken not to do so.

3. Ongoing monitoring of execution quality. The FSA proposes new obligations to assess the quality of execution that firms actually achieve. It proposes that firms should monitor the quality of the executions achieved on a

regular and systematic basis in order to give some assurance to the firm and its customers, as well as the FSA, that its execution arrangements do in fact operate in the customers' best interests. The proposed process would involve sample selection, choosing comparative data and a comparative assessment of execution quality. This should identify those executions falling outside the comparative data which should then be investigated to be followed by appropriate remedial action.

WHO AND WHAT IS AFFECTED BY THE PROPOSALS?

As matters stand, best execution rules do not apply to market counter parties, and will generally affect brokers executing orders for customers and investment managers executing orders for investment clients. In its proposals, the FSA agrees to retain the flexibility of allowing intermediate customers to waive best execution protection, although it emphasises that it will be for firms to demonstrate that foregoing the best execution protections is appropriate for that particular customer, and that their agreement has been evidenced in writing. The FSA proposes to retain the best execution obligation with regard to transactions executed as principal as well as agent, reflecting the current position.

The FSA proposes that best execution shall continue to apply to all designated investments with the exception of life policies and units in regulated collective investment schemes purchased by or sold to the operator. It is also proposed to remove the ability to delegate firms' best execution obligations. Accordingly, while firms may pass orders to others for execution, the firm passing the order will retain the obligation to deliver best execution.

The FSA's proposals have rejected a suggestion that best execution should not apply to programme or basket trading (purchase or sale of a group of securities as a single bargain, where the present rule requires best execution to be achieved for each component security within the basket), but do propose modifying the obligations in relation to such trading. In relation to internalisation, where a firm itself is the execution venue and counter party to the customer, and where the firm is at the same time acting on behalf of its customer and on its own behalf, the FSA indicates that in view of the clear conflict there must be protection by compliance with the best execution obligation in such circumstances. Similarly, where firms "cross" transactions by a process of execution involving buy and sell orders being matched between customers of the firm, the FSA indicates that the firm should owe a duty of best execution to *each* of its customers and that therefore the price must be one which is compatible with the obligations owed to each.

The FSA considered that the revised best execution rules should also apply to derivative and OTC markets, albeit that it may be difficult to achieve where there are few price comparisons.

CONCLUSIONS

The FSA's proposals, if they are subsequently implemented, will involve very significant changes in the obligations upon firms to achieve best and timely execution. The obligation of best execution itself will involve and oblige firms to take into account many more factors than have previously been relevant in order to achieve the "best outcome" or "quality of execution". The obligation of timely execution would be completely revised and will move away from an immediacy benchmark, to be replaced with a benchmark or standard which is arguably more difficult to meet. The previous "safe harbour" available to firms dealing on SETS would be removed.

Additionally, firms would need to provide what would appear to be a considerable amount of additional information about their execution arrangements to customers, and such information is likely to need monitoring and updating on a regular basis. At the same time, they will be obliged to conduct a review at least annually of their execution arrangements and justify their conduct following such reviews. The monitoring process in relation to best

execution is likely to be a good deal more extensive in light of the FSA's proposals.

The FSA has said that it will not at this stage issue draft rules until responses to the Consultation Paper itself have been evaluated and, in particular, European policy making in relation to the revisions to the Investment Services Directive is further advanced. The Consultation Paper contains a number of detailed questions and the FSA is seeking responses to those particular questions and will no doubt consider other views, the consultation period running until 31 January 2003. The FSA indicates that it expects to issue draft rules for consultation later in 2003.

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